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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1950

No. 415

ADELAIDE H. KNIGHT,

Petitioner,

against

COMMONWEALTH & SOUTHERN CORPORATION AND SECURITIES AND EXCHANGE COMMISSION,

Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

T. ROLAND BERNER,
Counsel for Petitioner.

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Petitioner, a holder of the option warrants of the Commonwealth & Southern Corporation, prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Third Circuit entered in the above case on August 23, 1950.

Opinions Below

The findings and opinion of the Securities and Exchange Commission are to be found at R. 29 et seq. The opinion of the United States District Court for the District of Delaware appears at R. 17-18 and 84 F. Supp. 809. The opinion of the Court of Appeals is to be found at R. 111 et seq. and 184 F. (2d) 81.

Jurisdiction

The jurisdiction of this Court is invoked under 28 U. S. C. 1254, made applicable by Section 25 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79y).

Statute Involved

Section 11(e) of the Public Utility Holding Company Act of 1935 provides in pertinent part as follows:

> "(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted, or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. * * *"

The Question Presented

Was it error of law to affirm a judgment approving a plan which extinguished the option warrants without compensation where

1. The SEC refused to give recognition to the acknowledged value inhering in the warrants with their perpetual call feature;

2. The SEC failed to apply to the option warrants the appropriate tests of value;

3. The SEC wholly ignored the fair market value of the option warrants?

Statement

The District Court entered an order enforcing the SEC's order of approval, under Section 11(e) of the Public Utility Holding Company Act of 1935 (15 U. S. C. A. § 79k (e),) of an amended plan for the dissolution of The Commonwealth and Southern Corporation (hereinafter called "Commonwealth"). The Court of Appeals affirmed the order.

This petition is submitted on behalf of the petitioner and all other holders of option warrants. At stake are option warrants worth approximately $12,750,000.

The Amended Plan. The amended plan provides for continuation of the enterprise via a successor corporation for distribution of the stock of this corporation and all the other assets of Commonwealth among its preferred and common stockholders, for the dissolution of Commonwealth, and for the extinction of the option warrants upon said dissolution without giving the warrant holders new warrants or any other "equitable equivalent".

Findings of the SEC. The SEC approved the amended plan, under Section 11(e) of the Act, as "necessary" to effectuate the provisions of Section 11(b) of the Act and as "fair and equitable" to all persons affected thereby. With respect to the option warrant holders, the SEC found "that the option warrants have no recognizable value and that the holders of such warrants are not entitled, under the standards of fairness and equity, to any participation in the reorganization of Commonwealth" (R. 88). It further found, in disapproving proposed plans to give new options in place of the old ones: "If warrants were issued

as provided under these proposed plans, it would constitute a decrease in the participation of common stockholders which we have found fair and equitable". (R. 102.)

Opinions of the Courts Below. In its decision enforcing the SEC's order, the District Court found it "Regrettable that the holders of option warrants do not participate at all under the amended plan." 84 F. Supp. at 111, (R. 18). The District Judge, however, believed he was compelled to defer to the views of the SEC and he accordingly directed enforcement of its order.

The Court of Appeals, rejecting the approach taken by the Second Circuit in *SEC* v. *Leventritt,* 179 F. (2d) 615, affirmed, while saying: "In reaching this conclusion, we are not unaware of the similarity in the two cases." (R. 118.)

A petition for rehearing, based on the representation of the Securities and Exchange Commission to this Court, in the *Niagara Hudson* warrant case (Nos. 211, 212), that the "decision creates a clear conflict with that of the Second Circuit" was denied.

Specification of Errors

The Court of Appeals erred:

(1) In holding that the conclusions of the Securities and Exchange Commission were arrived at in accordance with legal standards;

(2) In holding that there was substantial evidence to support the Commission's decision.

Reasons for Granting the Writ

This case raises a question of substantial importance in the administration of the Public Utility Holding Company Act. The issues, moreover, are substantially identical with those on which a contrary conclusion was reached by the

Second Circuit in *Securities and Exchange Commission* v. *Leventritt,* 179 F. (2d) 615, certiorari granted (*In re Niagara Hudson Power Corp.*)

On its petition for certiorari in the *Niagara* case (No. 212) the Securities and Exchange Commission filed a supplemental memorandum which begins:

> "This memorandum is submitted in order to bring to the attention of the Court the decision of the Court of Appeals for the Third Circuit in *In the Matter of The Commonwealth & Southern* Corp., on August 23, 1950, reprinted as an appendix hereto, *infra,* pp. 5-14. That decision creates a clear conflict with that of the Second Circuit in the instant case.
>
> Like this case, the *Commonwealth & Southern* case involved a reorganization of a holding company pursuant to Section 11(e) of the Act, in which one of the issues was the treatment to be accorded to perpetual warrants giving the holder thereof an option to purchase common stock of the company at $30 a share. The Commission approved a plan of reorganization which, *inter alia,* excluded the warrant holders from participation."

and concludes:

> "The Third Circuit refers to the decision of the Second Circuit, noting "the similarities in the two cases" and the latter court's agreement that the Commission's findings must be affirmed if supported by substantial evidence and arrived at in accordance with the legal standards (pp. 13-14, *infra*), but an analysis of its opinion makes it clear that what the Third Circuit regarded as "abundant evidence" (p. 14, *infra*), the Second Circuit regarded as neither substantial nor insubstantial (R. 126); and that past market history, which the Second Circuit regarded as "positive evidence" of value (R. 124), the Third Circuit considered of little, if any, significance.
>
> It is clear, therefore, that there now exists a conflict of decisions in the circuits on the issue presented by

the petition herein, which provides an additional reason for granting the writ."

Argument

The Securities and Exchange Commission, in this case and the *Niagara* case, has laid down a very simple test to determine whether or not a perpetual option warrant has "recognizable value".[1] Unless the common stock, at the time of the approval of the plan, is worth the option price—or very close to it—the warrant has no "recognizable value". It is this proposition which the Second Circuit correctly found there was no "evidence 'substantial' or insubstantial to support." It is this test which the market history of these warrants *and all other warrants* unequivocally refutes.

In *Electric Power & Light Corp.*, Holding Co. Act Release No. 8889 (1949), pp. 70-74, affirmed 176 F. (2d) 687 (C. A. 2d) stay denied 337 U. S. 903, the Commission employed what is the only feasible method for measuring the value of perpetual option warrants: it reviewed the market history of the common stock and the market history of the warrants, and calculated the normal ratio of the two prices at levels such as then prevailed; this ratio was then used, with an adjustment, to determine the value of the warrants. The Commission and the Court of Appeals both rejected the contention of common stockholders that the warrant holders were entitled only to the exercise value of the warrants, i. e. the market price of the stock less the option price.

The Commission takes the position, however, that the *Electric Power* test should be employed only where the value of the common stock exceeds, or at least approaches,

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[1] By its consistent use of the phrase "recognizable value" the Commission implies that there are values which are not "recognizable." It is this viewpoint, at least insofar as it might be applicable to these warrants, which we believe to be at the root of its error.

the option price, this despite the fact that this test takes into full account, in its operation, the difference between the market and the option price. No reason is given for the rejection of the *Electric Power* test in other cases; the Commission simply disagrees with the standard of value which governs in the market place and has asserted the right to supersede that standard by a new one of its own creation. The market places a value on a perpetual right to buy a stock at two, three, four or five times its current market price; the Commission says it is worthless and by its *ipse dixit* undertakes to make it so.

We do not question the correctness of the Commission's general approach to the problem of valuing the common stock of Commonwealth. The method of estimating foreseeable earnings, on the basis of available evidence, and multiplying them by the capitalization factor normally prevailing in the market for similar securities, is realistic and well established. This method, employed by willing buyers and willing sellers, has been adopted by this Court and the Commission and in the long run determines market prices.

The Commission naturally cannot be governed by the current market prices of the securities it is valuing, because these prices reflect anticipations of the action of the Commission. On the other hand, it cannot ignore the market prices of securities generally, or totally reject the prevailing yield and capitalization factors. It cannot value a well-secured preferred stock on a 7% yield basis if such stocks generally sell to yield 4%. It cannot say a good utility, common stock is worth twenty times annual earnings if the market appraises such stocks at twelve times earnings. By the same token it cannot say that the perpetual right to buy a stock at, say, four times its current value is worthless, where the market invariably assigns real value to such a right.

It must be kept in mind that warrants, unlike stock, do not sell on a yield or "times earnings" basis. They are not bought for income but represent, in the words of Learned Hand, C. J., at 179 F. (2d) 727, ". . . a willingness to pay cash for the chance that the market's judgment as to the future of the property may be too unfavorable". This chance, to be valuable, need not be "probable" in the sense of more than 50% probable—as the Commission uses the word. In the nature of things it cannot be "reasonably foreseeable", for if it were, it would be reflected in the price of the stock, which would approach the option price. By requiring, as a test of any value, a "reasonable expectation" that the market price of the stock will exceed the option price within the "foreseeable future", the Commission denies warrant holders, *by definition,* any premium value. This self-defeating test is error of law.

The error of the Court of Appeals was to assume that the evidence with respect to the current value of Commonwealth common stock was evidence of worthlessness of the warrants. The Commission's major premise, discussed above, was apparently accepted without question, despite the complete absence of evidence to support it. It was the Second Circuit's rejection of this premise that necessarily produced the contrary result in the *Niagara* case.

In concluding that the result below is required by the decision of this Court in *SEC v. Central-Illinois Securities Corp.,* 338 U. S. 96, the Court of Appeals for the Third Circuit overlooked the test of value so clearly stated in the opinion of the late Mr. Justice Rutledge at p. 1318 (93 L. Ed. Ad. Op.):

> ". . . 'the most workable hypothesis for finding a fair equivalent between cash received and the security surrendered under the compulsion of the plan, is that of reinvestment in a security of comparable risk.' The question to which the Commission seeks the answer is,

'How much money would it cost the preferred stockholders to replace their securities with comparable ones?' "

Since it may now be too late to give the warrant holders the new warrants in the successor corporation which they originally requested, they should be given cash sufficient to enable them to buy similar warrants. This amount is far from zero: for the more than 17,000,000 warrants outstanding we have estimated it to be about $12,750,000.

Conclusion

For the reasons stated it is respectfully requested that the Writ of Certiorari be issued.

T. Roland Berner,
M. Victor Leventritt,
Aaron Lewittes,
Counsel for Petitioner.

November 20th, 1950.

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DEC 27 1950
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ON A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE COMMONWEALTH & SOUTHERN CORPORATION

GEORGE ROBERTS,
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APPEAL PRINTING CO., INC., 130 CEDAR STREET, NEW YORK, WO 4-3033

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MEMORANDUM FOR THE COMMONWEALTH & SOUTHERN CORPORATION

Statement

While we agree that the issues in this case and in the cases of *Niagara Hudson Power Corporation* v. *Leventritt* and *Securities and Exchange Commission* v. *Leventritt*, Nos. 211 and 212, in which oral argument was presented to this Court on December 5, 1950, are so similar that a reversal in that case would necessarily mean an affirmance here, nevertheless, we do not at all agree that the issues are identical or that an affirmance in that case would necessitate a reversal in this.

In this case there was introduced not only the testimony as to the probable future earnings of the Commonwealth system and other evidence of value as well as evidence of market value of the option warrants, but there was also introduced opinion evidence to the effect that the warrants had no value (R. 59a, 60a).

Mr. Whiting, the President of Commonwealth, in testifying as to the fairness of the proposed plan and the provisions thereof with respect to the Option Warrants said:

> "If we were to capitalize common stock earnings at 20 times, which in my judgment is more than liberal, it would require earnings of $1.50 per share to make the common stock worth $30. per share. After all unpaid and accrued dividends on the preferred have been paid this would require earnings if paid up in the amount of 75% of those available of over 78 million dollars. Even if all earnings were paid up by the operating companies to the Corporation, which is impracticable, it would require earnings of over 59 million dollars. The members of the Board saw no prospect of making such earnings and therefore made no provision for the warrants."

Mr. Hartt, an independent engineer having no interest in Commonwealth and a qualified expert in the valuation of utility securities, in his testimony relating to the value of the various securities of Commonwealth, stated:

> "I can see no real value in the rights that the option warrant holders now have."

The following is an excerpt from the transcript of his testimony:

> "Q. Will you also state your reasons for considering the plan to be fair and equitable in making no provision for the option warrants? A. I think

> it is fair and equitable in not making any provision for the option warrants, because I can see no real value in the rights that the option warrant holders now have. It is almost inconceivable that the consolidated earnings applicable to the common stock of the Company will increase in the foreseeable future to such an extent that the option warrants would have any value. * * *"

Accordingly, irrespective of whether evidence as to the reasonably prospective future earnings is sufficient by itself to constitute substantial evidence that the Warrants have no value, there is here ample justification for the holding of the Circuit Court of Appeals when it said:

> "The Second Circuit decision in S.E.C. *vs.* Leventritt, 179 F. 2d 615, involving the reorganization of the Niagara Hudson Power Corporation, agrees that where the Commission's holding is supported by substantial evidence and was arrived at in accordance with legal standards, it must be affirmed. But in that opinion the Court found that the record contained nothing to sustain the Commission decision that the Niagara options were valueless. We take the view, already expressed, that the record in the case before us contained abundant evidence to support the Commission's decision. In reaching this conclusion, we are not unaware of the similarities in the two cases.
>
> On the evidence, the Commission properly held that the Commonwealth option warrants had 'no recognizable value'. Applying the 'fair and equitable' test, it found that the warrants were not entitled to any participation in the reorganization of Commonwealth. In so deciding, we think that the Commission was within its statutory authority and that the District Court correctly approved its action.
>
> The judgment of the District Court will be affirmed."

We submit that in this case there is no reason for granting a writ unless this Court desires to reconsider the doctrine previously announced by it that where a Commission's holding is supported by substantial evidence and was arrived at in accordance with legal standards, it must be affirmed.

In the memorandum of the Securities and Exchange Commission the following suggestion is made:

> "In view of the present status of the Niagara Hudson case, however, we submit it is a matter for this Court's discretion whether it would be more appropriate to grant the writ and set this case for an early argument or to defer action upon this petition until after the Court's decision in Nos. 211 and 212."

We submit that the writ in this case should either be denied or if it is to be granted, that it be set down for argument before a decision is reached in the Niagara Hudson cases.

Respectfully submitted,

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HAYDEN N. SMITH, Esq.,
Of Counsel.